U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	1987.2	1987.3	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1985	1986	1987	1988	1989
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4445	4524	4596	4638	4691	4760	4833	4922	4010	4235	4486	4731	5056
% Change	6.3	7.3	6.5	3.7	4.6	6.0	6.3	7.5	6.3	5.6	5.9	5.5	6.9
% Change (w/out inflation)	2.5	4.3	3.0	1.0	1.6	2.7	2.6	3.0	3.0	2.9	2.9	2.3	2.8
Consumer Price Inflation (CPI)	4.9	3.9	3.8	3.8	4.1	4.3	4.7	4.7	3.6	1.9	3.7	4.1	4.6
GNP Inflation (GNP Deflator)	3.5	2.8	2.7	2.7	3.0	3.2	3.6	4.4	3.2	2.6	3.0	3.1	4.0
Unemployment Rate - Civilian	6.2	6.0	5.9	6.0	6.2	6.2	6.2	6.1	7.2	7.0	6.2	6.1	6.0
Civilian Employment-Household Basis (millions)	112.2	112.9	113.4	113.7	114.0	114.4	114.8	115.2	107.2	109.6	112.4	114.2	116.0
Percent change	2.4	2.4	1.9	1.1	1.0	1.3	1.4	1.6	2.0	2.3	2.6	1.6	1.5
Index of Industrial Production	128.2	130.8	132.6	132.9	133.3	134.6	135.7	137.1	123.7	125.1	129.6	134.1	139.0
Manufacturing Capacity Utilization	80.5	81.4	82.0	81.8	81.8	81.8	81.7	81.8	80.1	79.7	81.0	81.8	81.9
Domestic Auto Sales	7.0	8.0	6.4	6.0	6.5	6.8	6.8	6.9	8.2	8.2	7.0	6.5	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.8	20.4	20.2	20.0	20.1	20.0	20.2	20.5	19.7	19.5	20.4	20.1	20.5
Federal Expenditures (NIPA) as % of GNP	23.9	23.4	23.9	23.8	23.6	23.5	23.5	23.4	24.6	24.4	23.8	23.6	23.2
Deficit(NIPA)	-139.2	-136.1	-169.5	-172.4	-163.9	-166.9	-162.7	-158.8	-196.0	-204.7	-153.8	-166.5	-123.0
as % of GNP	3.1	-3.0	-3.7	-3.7	-3.5	-3.5	-3.4	-2.8	4.9	4.8	-3.4	-3.5	-2.6
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4718	4542	4499	4264	4302	4255	4419	4397	4254	4717	4649	4310	4512
Percent change -- year ago	1.3	-3.4	-10.3	-11.8	-8.8	-6.3	-1.9	3.1	8.6	10.9	-1.4	-7.3	4.7
Existing Single-family Home Sales (thousands)	3610	3430	3420	3178	3193	3188	3338	3327	3214	3565	3520	3224	3412
Percent change -- year ago	3.8	-4.4	-12.1	-12.1	-11.6	-7.1	-2.4	4.7	12.1	10.9	-1.3	-8.4	5.8
Housing Starts (thousands)	1612	1610	1549	1537	1557	1520	1559	1573	1742	1819	1641	1543	1614
Percent change -- year ago	-14.2	-8.4	-9.0	-14.4	-3.4	-5.6	0.7	2.4	-1.4	4.4	-9.8	-6.0	4.6
Single-Family Units	1142	1147	1113	1119	1143	1100	1114	1103	1073	1188	1164	1119	1134
Percent change -- year ago	-6.2	-0.3	-4.0	-10.9	0.1	-4.0	0.1	-1.5	-2.4	10.8	-2.0	-3.9	1.3
Multi-Family Units	470	464	436	417	413	420	445	470	670	631	477	424	480
2-4 Family Units	73	58	54	52	51	52	55	59	93	65	66	53	60
Percent change -- year ago	-9.9	-24.8	-38.4	-35.1	-29.6	-9.4	2.1	12.6	-23.3	-8.6	-22.5	-20.4	13.2
5+ Family Units	397	406	382	365	362	368	390	412	576	566	411	371	420
Percent change -- year ago	-31.6	-23.6	-16.3	-20.4	-8.7	-9.4	2.1	12.6	5.5	-5.3	-24.7	-9.6	13.2
New Single-family Home Sales (thousands)	674	675	655	638	650	659	692	664	688	750	682	660	690
Percent change -- year ago	-15.1	-1.6	-7.9	-11.8	-3.6	-2.4	5.6	4.1	7.7	9.0	-9.1	-3.3	4.6
Mobile Homes Shipped (thousands)	227	241	237	240	246	243	247	248	283	249	234	244	255
HOME PRICES													
Existing Home Prices - Median ($1000)	85.1	85.5	84.5	85.7	87.3	90.2	92.5	93.4	75.5	80.3	84.9	88.9	93.6
Percent change -- year ago	3.7	5.9	5.4	1.7	2.6	5.5	9.5	9.0	4.3	6.4	5.7	4.7	5.3
New Home Prices - Median ($1000)	103.5	106.2	110.0	107.0	108.3	110.0	111.4	111.7	84.3	92.0	104.5	109.2	114.4
Percent change -- year ago	12.5	13.5	15.6	9.9	4.7	3.6	1.3	4.4	5.5	9.1	13.6	4.5	4.8
FINANCIAL MARKETS													
Long-Term Interest Rates													
30-year Fixed Rate Mortgage (FHA Secondary)	10.3	10.5	11.0	10.6	10.5	10.6	10.6	10.7	12.2	9.9	10.0	10.6	10.5
1-year ARM (without buydown)	8.1	8.3	8.3	8.4	8.3	8.5	8.6	8.6	7.6	7.9	8.2	8.5	8.6
Corporate AAA Bond Rate	9.2	9.8	10.2	9.9	9.8	9.8	9.9	9.9	11.4	9.0	9.3	9.9	10.0
Government Bond Rate	8.5	9.1	9.3	9.2	9.3	9.3	9.3	9.3	10.8	7.8	8.5	9.3	9.2
Short-Term Interest Rates													
Federal Funds Rate	6.7	6.8	7.0	6.9	6.8	7.1	7.3	7.4	8.1	6.8	6.6	7.0	7.3
3-month T-Bill Rate	5.7	6.0	5.8	6.0	6.0	6.2	6.3	6.5	7.5	6.0	5.8	6.1	6.3
Prime Rate	8.0	8.4	8.9	8.7	8.7	8.8	8.8	8.9	9.9	8.3	8.2	8.6	8.9
Discount Rate	5.5	5.7	6.0	5.9	5.8	5.9	6.0	6.0	7.7	6.3	5.6	5.9	6.3
Money Supply (M1)(% change)	6.5	0.0	4.7	4.5	6.7	6.6	6.3	6.6	9.1	13.3	11.3	4.9	6.4
Value of the U.S. Dollar (Trade-Weighted Avg.)	97.0	98.7	92.5	86.5	85.5	84.6	83.5	83.3	143.2	112.3	97.0	85.0	82.5
Percent change	-11.1	7.2	-22.7	-23.4	-4.8	-4.2	-4.9	-0.9	3.5	-21.6	-13.6	-12.3	-3.0

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy. Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

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REAL ESTATE OUTLOOK

Vol. 1, No. 3 March 1988

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- Real GNP growth in the first quarter of 1988 is expected to slow to an annual rate of 0.8 percent. The slower rate of production is due to high levels of inventories amassed during the fourth quarter of 1987. Growth in net exports and a rebound in consumer spending will bring the 1988 annual rate of real GNP growth to 2.5 percent.
- Weak economic growth in the first half of 1988 will not support a high rate of inflation, holding consumer price increases to an average annual rate of 3.7 percent in the first six months of the year. For all of 1988, consumer prices are expected to rise 3.9 percent and by 4.6 percent in 1989, when measured on a year-over-year basis.
- The risk of faster rates of inflation is relatively low. However, as more U.S. industries operate at levels close to capacity to respond to the increased demand for U.S. exports, higher rates of producer price inflation could feed through to higher prices on consumer goods.
- Federal Reserve Board Chairman Greenspan announced that the Fed had eased monetary policy earlier this year, allowing interest rates to decline. Recent signs of stronger economic growth lead him to doubt the Fed will ease further unless those positive indicators turn sour. Consequently, short-term interest rates are expected to rise in the second half of 1988.
- Mortgage interest rates are also expected to rise in the second half of 1988, due in part to the quickening pace of inflation. The average secondary market yield on 30-year FHA-insured mortgages will increase to over 10.5 percent by the end of 1988, but average only 10.3 percent for the entire year.
- January sales of existing homes declined 3.6 percent to a seasonally adjusted annual rate of 3.21 million units. Higher mortgage rates and an over-extended consumer were the likely causes of the third consecutive monthly decline. The current window of lower mortgage interest rates, coupled with a rebound in consumer spending, will help sustain demand for existing homes at an annual rate of about 3.24 million units in 1988.

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TAKING THE LONG VIEW:
Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

Economics is as much psychology and culture as it is graphs and numbers. The major effects of the stock market crash of 1987, as we feel them now in the economy, have come about because of our psychological reaction. Consumers withdrew from the market not because their incomes fell (although for some this was true), but because they were convinced by the pundits and the media that the sky was falling. In fact, the crash will diminish real growth in 1988 by about 0.5 percent. But for now, the crash has left the consumer in a mixed-up mood.

Culture is also a factor in things economic. Ask anyone on the street who is the U.S.'s biggest economic competitor and you will inevitably be told the Japanese. Probe further as to reasons and the responder will inevitably cite work ethic, savings rate, newer capital, etc. In other words, our economic competition not only works with better equipment, but has a culture more suited to efficiency and profitability than our own.

Much of this is true, and perhaps the greatest cultural advantage the Japanese have is the ability to take the long view. The accomplishments of their economy over the past two decades have been built on the view that incremental accomplishments and the provision of quality will ultimately produce world economic leadership. They have focussed on the places they needed to be ten years hence, rather than next week or next month.

But, as the recent declines in consumer spending and housing starts show, we have built an expansion by focussing on today. We have built an expansion by borrowing from the future; we have not made the investments necessary to create the human and machine capital we need to sustain growth.

Our economic growth has come predominantly in service industries and mostly in entry-level jobs. We are training an entire generation to follow routine with little or no understanding of why or even how. Moreover, we're even replacing numbers on cash registers with words or pictures to further remove any mental challenge from these jobs. Yes, I'm being a little peevish here, and yes, I know that Thomas Edison and Steve Jobs came from somewhat obscure origins, but that's not the point. We will always have the entrepreneur and the technical genius overcome environment. But we are missing the tinkerers, the technicians and the mechanics that made American manufacturing competitive. We are not making the human investments we need for the future.

Is there a solution? Yes, there is, but it requires that we eat the elephant one bit at a time. As a people, we cannot build for the future if we insist on piling up enormous debts now. We need to slow the growth of consumer, government and international trade debt as a prelude to reducing it. For individuals, this requires an increased devotion to thrift. Our savings rate is currently at an historical low. It is insufficient to sustain the total volume of public and private debt that now exists. Unless we can bring that rate up, and reduce the burden of consumer debt, we are sentenced to continual high interest rates and a sluggish economy, or worse. When private debt is under control, it then becomes easier to tame the profligacy of the public sector.

In the book of Genesis, Joseph makes the climb from prisoner to prince by cautioning Pharaoh against the coming lean years, and then directing the conservation of resources against that time. Coincidentally, this current expansion will enter its seventh year next November. Now is the time to use our prosperity to build an equally prosperous future.

Outlook for the Economy and Real Estate

THE ECONOMIC OUTLOOK

Last month's announcement by the U.S. Commerce Department that the annual rate of real GNP growth for the fourth quarter of 1987 reached 4.2 percent immediately triggered warnings from many economists that too much of that growth was due to inventory accumulation. Production is expected to slow in the first quarter (and perhaps the second) as businesses attempt to sell off their excess inventories. How quickly excess stocks are depleted depends both on the extent of the expected rebound in consumer spending and the staunchness of foreign demand which is spurring on the current export boomlet. While severe winter weather combined with aftershocks from the new tax code are probably behind the housing starts decline (and not an all out housing starts bust), the sluggish activity will still drain first quarter GNP growth. The net effect of these forces on the current forecast is that the annual rate of real GNP growth is expected to slow considerably in the first quarter of 1988, to an annual rate of about 0.8 percent -- down slightly from the February forecast of 1.0 percent. On a year-over-year basis, real GNP growth is expected to reach 2.5 percent in 1988, somewhat slower than the 2.9 percent pace of 1987.

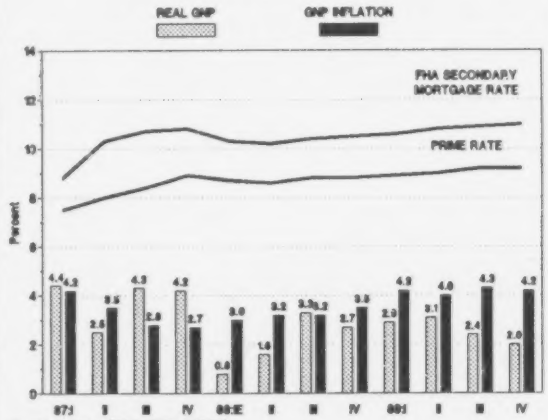
The Lowdown on High Inventories

The preliminary report on the annual rate of first quarter real GNP growth is not due to be released for two months, but already there are confirming signals that inventories are indeed swamping many businesses. The most recent data available shows business inventories in manufacturing and wholesale and retail trade rose 1.1 percent in October, 0.9 percent in November and 0.8 percent in December. The fourth quarter average rate of increase of 0.9 percent was well above the 0.5 percent average advance of the first nine months of 1987. In a sense, inventory accumulation in manufacturing industries is not as worrisome as the trade inventories because much of these stocks are intended for export. High retail and wholesale inventories are potentially troublesome because domestic demand from the U.S. consumer has been flagging in recent months.

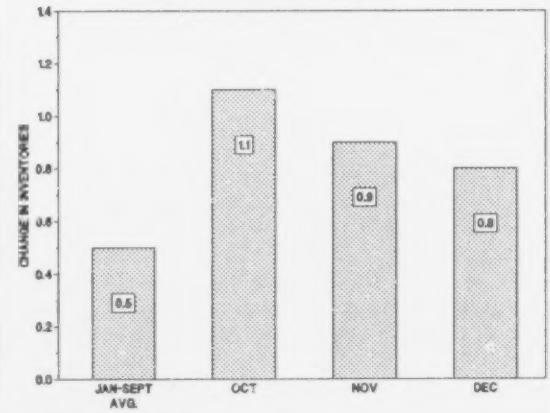
Consumer Spending Rebound

However, recent data on retail sales may indicate that consumer spending is on the rebound, which may help reduce excess inventories. In January, total retail sales were reported up 0.5 percent from their December level, and up by 0.2 percent if auto sales are excluded. In addition, December and November retail sales figures were revised upward by a total of 0.6 percent. The revised estimates show that retail sales surged ahead 1.2 percent in December (0.9 percent excluding autos) and 0.3 percent in November (0.6 percent excluding autos). According to estimates made by the Conference Board, the consumer seems to have regained much of the confidence lost in the wake of the stock market crash. In sum, while real consumer spending declined in the fourth quarter of 1987, it appears that the consumer will reverse that trend in the first quarter, possibly softening the effect of the expected production slowdown.

GRAPH 1: THE ECONOMIC OUTLOOK

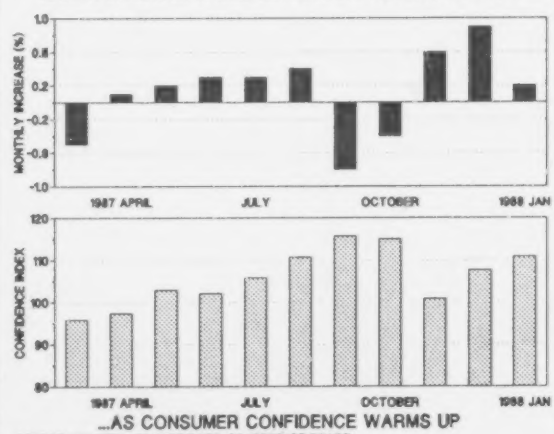


GRAPH 2: MANUFACTURING AND TRADE INVENTORIES END 1987 AT HIGH LEVELS



SOURCE: U.S. DEPT. OF COMMERCE

GRAPH 3: RETAIL SALES (EXCLUDING AUTOS) REVIVE...



...AS CONSUMER CONFIDENCE WARMS UP

SOURCE: U.S. DEPT. OF COMMERCE, CONFERENCE BOARD.

The Export Boomlet

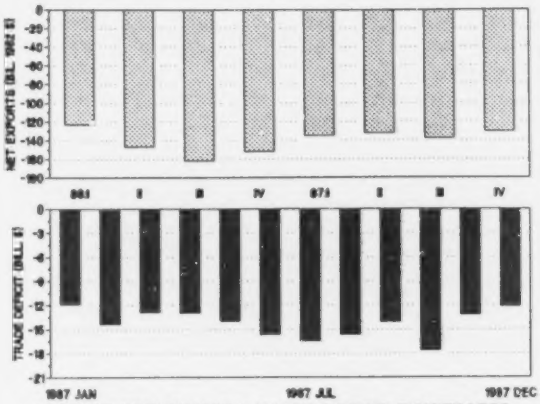
In two short months, the U.S. trade sector has shrugged off the mantel of economic deadbeat and is poised as potentially the largest and steadiest source of economic growth in 1988. Part of this transformation is simply a matter of perspective: real net exports have contributed positively to the economy since the fall of 1986 (with the exception of one quarter). That is, looking at the trade deficit in volume terms (by adjusting for price changes), shows that real net exports are becoming *less negative*. In so doing, they are contributing *positively* to real GNP growth. Alternatively, the monthly statistics on the nominal trade deficit have not shown steady improvement, until now. In December, the trade deficit fell to $12.2 billion from the November gap of $13.2 billion. However, most of the excitement was focused on the November statistic, with good reason: it marked a 25 percent decline from the $17.6 billion October trade deficit, the largest monthly shortfall during 1987. With the exception of the October statistic, the trade deficit declined throughout the second half of 1987.

Moderate Inflation Expected

The appearance of having reached the turning point with the trade deficit has helped ease the run on the dollar that began in December (the month in which the October trade report was released). The more stable dollar has in turn helped calm fears of runaway inflation in 1988. Slow economic growth through the first half of 1988, characterized by generally weak domestic demand, will also help hold down inflation. Higher prices on imported goods are expected to claim a share of consumer price inflation in 1988, as foreign producers finally pass on the cost of the lower value of the dollar to American consumers. Consumer prices are projected to rise at an average annual rate of 3.8 percent in the first half of 1988, and by an average annual rate of 4.5 percent in the second half. On a year-over-year basis, consumer prices are expected to rise by 3.9 percent this year, and by 4.6 percent in 1989.

There is a significant risk to this moderate inflation forecast. First, if expected fluctuations in the monthly trade deficit prove too disconcerting for investors who hold dollars, the result could be another run on the dollar. If such a run were not managed by the world's monetary authorities as successfully as the run on the dollar in December, then the rate of inflation could rise. A more likely cause of higher than expected rates of inflation lies within our own borders. High rates of industrial production are pushing plants in many industries to produce at capacity levels. Some of this extra production is being sold overseas, accounting for the apparent trade turnabout. But, if domestic spending revives more strongly than expected, and before U.S. manufacturers can expand capacity, then U.S. manufacturers would face excess demand at high levels of capacity: a perfect recipe for higher prices. There is already some evidence that producers are charging each other higher prices for intermediate (unfinished) goods, which could lead to higher prices of finished goods. In sum, the U.S. economy can not expand at a rate of more than 2.5 percent in 1988 without risking another bout with higher prices.

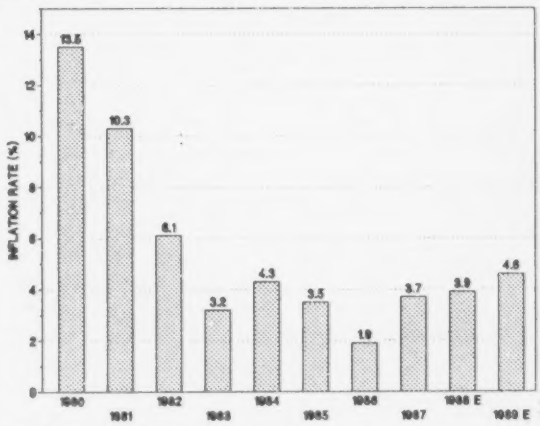
GRAPH 4: REAL NET EXPORTS HAVE IMPROVED SINCE 1986...



...BUT THE 1987 MONTHLY TRADE DEFICIT FLUCTUATES

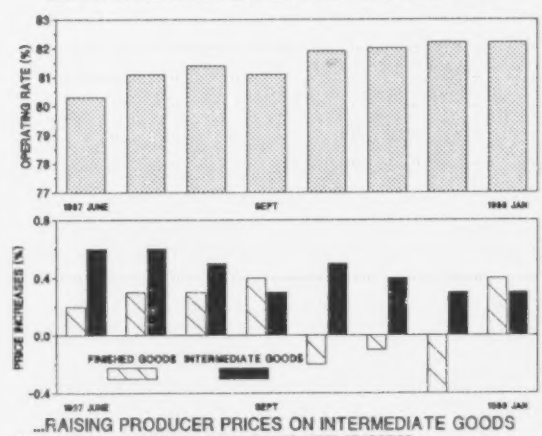
SOURCE: U.S. DEPARTMENT OF COMMERCE

GRAPH 5: MODERATE CONSUMER PRICE INFLATION EXPECTED



SOURCE: DEPT. OF COMMERCE; NAR ESTIMATES (E)

GRAPH 6: CAPACITY UTILIZATION RATES ARE HIGH...



...RAISING PRODUCER PRICES ON INTERMEDIATE GOODS

SOURCE: FEDERAL RESERVE BOARD, BUREAU OF LABOR STATISTICS

Monetary Policy and Interest Rates

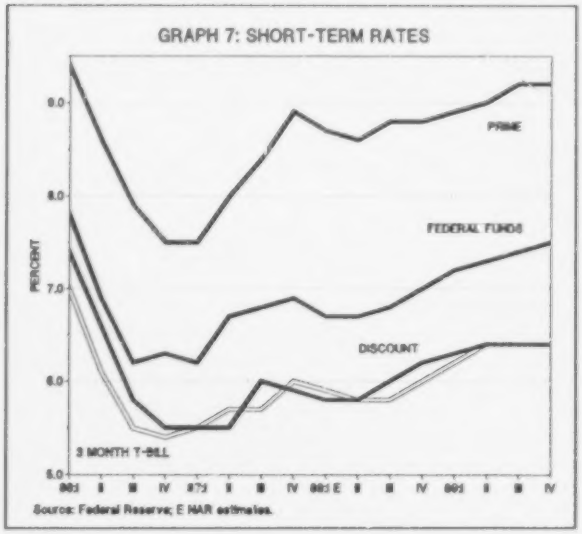
Looking for signs of how the Fed might be positioning its monetary policy is a key to understanding some of the other economic indicators. This month, there are fortunately two accounts of public statements by Fed Chairman Alan Greenspan that relate to the course of monetary policy. The first came in Greenspan's first full report to Congress on monetary policy, which he delivered in testimony before the House Banking Committee on February 23. In his presentation, he admitted that the Fed had taken a "further small easing step a few weeks ago." But, he also implied that the Fed would not loosen any further unless new signs of a weakening economy came to light. This means that short term interest rates are not expected to decline much further unless the economy weakens noticeably. The second insight came in comments by Chairman Greenspan regarding an attempt by a Treasury Department official to influence monetary policy. Chairman Greenspan warned that such interference by non-Fed officials could lead to Fed actions designed to assert the Fed's independence from the White House. This was taken by some Fed-watchers as further evidence that the Fed is not backing away from high interest rates in an election year.

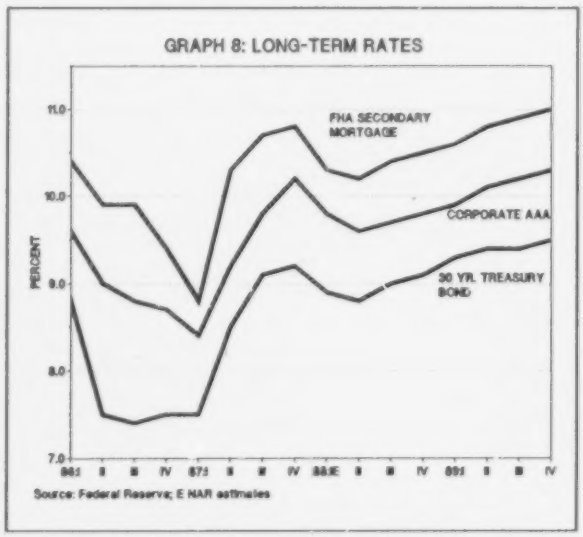
In recent weeks, long-term interest rates have been trending down, to the point where fixed rate mortgages are available at interest rates below 10 percent. With inflation fears on the wane, a modest bond market rally managed to drop long-term yields to these lower levels. Much deeper declines in mortgage rates are not expected. Gradual declines in the dollar in late 1988, should lead to faster inflation and rising mortgage rates in the second half. Furthermore, while trade will improve in real terms, continued fluctuation in reported monthly trade figures will lead investors to demand higher yields on long-term assets. Mortgage rates are expected to end the year above 10.5 percent, but average 10.3 percent for all of 1988.

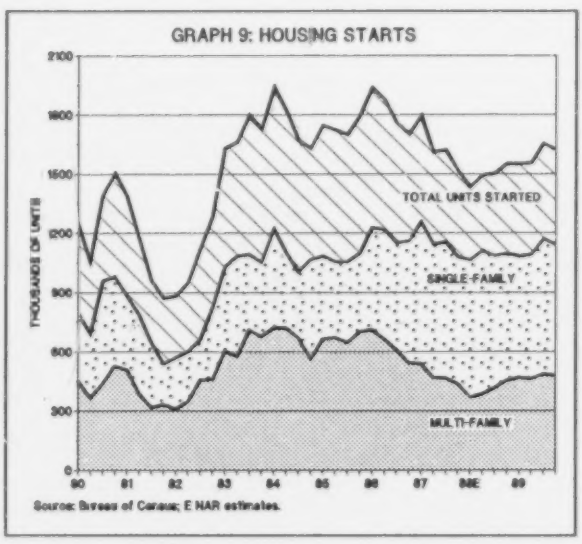
REAL ESTATE MARKETS

Housing Starts

Housing starts have begun to fluctuate wildly in recent months, raising questions both about the strength of the housing market, and the accuracy of the seasonal factors used to factor in effects such as cold winter weather. In January, privately owned housing units were started at a seasonally adjusted annual rate of 1.377 million units, 2 percent below the December rate of 1.404 million units, and 24 percent below the January 1987 rate of 1.804 million units. There is some evidence that extreme winter weather in many parts of the country (beyond what is normally accounted for by the seasonal adjustment) was responsible for the large decline from the January 1987 annual rate. For the entire year, privately owned housing starts were estimated to have reached 1.621 million units in 1987, a 10.2 percent decline from the 1986 rate of 1.805 million units. After a projected slowdown in starts activity in the first half of 1988, starts should rebound in the second half to reach an annual total of 1.494 million units, down 8 percent from their 1987 level.

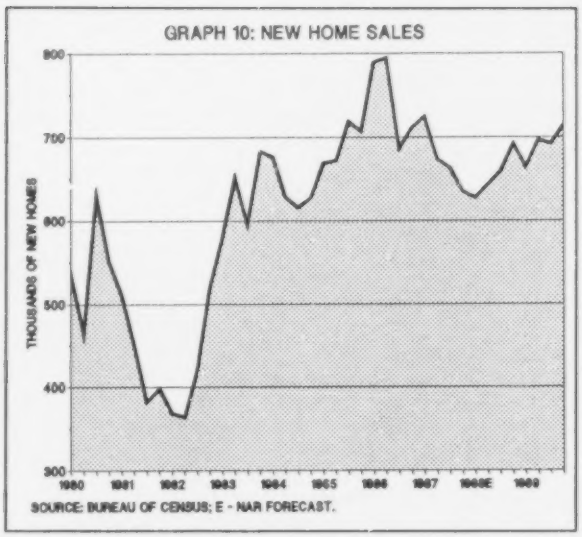






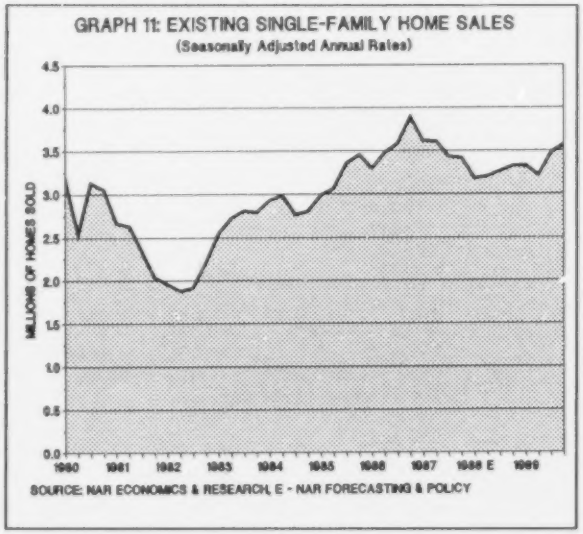
New Home Sales

Sales of new single-family homes totaled 674 thousand units in 1987, down 10 percent from the 1986 total of 750 thousand homes. The year ended on a down note, with the annual rate of new single-family home sales slowing to only 603 thousand units in December, 6.2 percent off November's annual pace of 643 thousand units. The December rate was the slowest annual rate in 36 monthly reports. On a regional basis, new home sales declined 51 percent in the Northeast during December, offsetting sales gains in the Midwest and South (sales were unchanged in the West). New home sales are expected to continue to decline slightly through the first quarter of 1988. The rate of new home sales will likely pick up in the second quarter and continue to rise modestly through 1988. Total new home sales are expected to reach 655 thousand units in 1988, about 3 percent below the 1987 annual rate. In 1989, new homes are projected to be sold at annual rate of 687 thousand units.



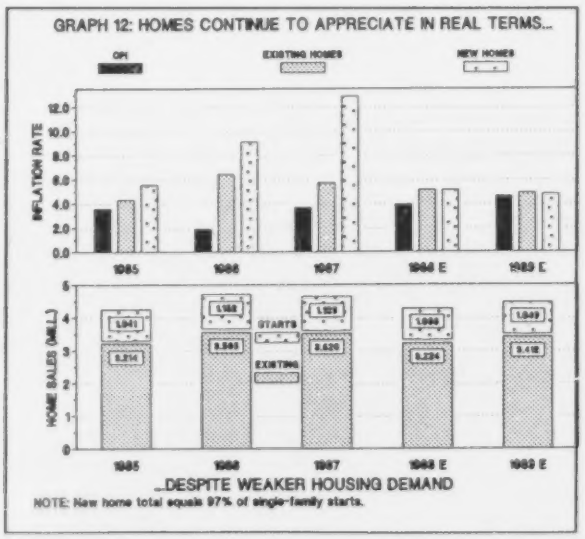
Existing Home Sales

January sales of existing single-family homes fell to a seasonally adjusted annual rate of 3.21 million units, 3.6 percent below the December annual rate of 3.33 million units. The January drop was the third monthly decline since existing home sales reached an annual rate of 3.47 million units in October. It also placed existing home sales at the lowest level of activity since June 1985. Higher mortgage rates and an over-extended consumer are the likely causes of the decline in home sales. January home sales declined in all regions except the Midwest, where the rebound in export demand is likely to have the greatest impact in 1988. After a two year period in which more than 7 million homes were sold, existing home sales are expected to decline modestly in 1988. However, the current forecast also projects a revival in consumer spending this year that could help drive home sales to consecutive quarterly increases from the expected first quarter's annual rate of 3.178 million units. The 1988 total of existing single-family home sales is expected to reach 3.24 million units.



Home Prices

Despite the three month decline in existing home sales, existing home prices have risen over the same period. In fact, the median price of an existing home rose to $87,900 in January, up 2.9 percent from the December median price of $85,400. Existing home prices are expected to increase by 5.1 percent in 1988, 1.2 percent faster than the 3.9 percent rate of consumer price inflation. New home prices are also expected to continue to increase in real terms in 1988. It is expected that the distortion of the new home sales sample toward higher income buyers, brought about by higher mortgage rates in 1987 will be less pronounced in 1988, explaining the decline in the expected rate of new home price appreciation.



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Secondary Market Outlook

by
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The second level of shock waves from the slowdown in mortgage demand is now being felt. Mortgage lending operations, large and small, continue to shrink. Most recently, Lomas & Nettleton announced another 20 percent cut in staffing, bringing its total reduction to 40 percent since October.

For many lenders, particularly those who became mortgage bankers instantly through acquisition of loan servicing portfolios, the dramatic drop in volume is a harsh lesson. From their perspective, a decline in new mortgage lending presents a twofold problem. First, there is no activity to support the fixed costs and production capacity built up in the high volume period that has just ended. Large processing staffs, extensive automation and sophisticated secondary marketing activities depend upon a heavy and sustained flow of loans through the pipeline.

Second, these lenders have accumulated a sizeable portfolio of loans which they service for a fee paid by the investor. The servicing portfolio is critical; it is traditionally the primary source of profits in mortgage banking. Front end fees charged to the borrower generally cover the cost of origination (processing, closing and putting the loan on the books) and fees paid to investors for commitments to purchase the loans.

Experienced mortgage bankers expect to break even on loan sales in the long run. They recognize that gains (i.e., an excess of points charged over costs and fees paid) in some markets will be offset by losses in others. In short, the profit margins between the primary and secondary mortgage markets are narrow.

The principal source of profit in mortgage banking lies in servicing--collection of payments, accounting, reporting and remitting to investors, maintenance of escrow accounts and other activities. But profitable loan servicing requires a high level of efficiency in performing many clerical, labor-intensive functions. Most servicing operations are highly computerized, but no computer can answer customer questions or complaints, or file the dozens of pieces of paper that each loan generates, or work out a payment plan for a seriously delinquent borrower.

Making servicing profitable has become more challenging in recent years, as a variety of loan types has evolved (the more varied the portfolio, the more potential for higher servicing costs). Additionally, the servicing fee on many transactions has narrowed--conventional mortgage backed securities, for example, generally involve servicing fees of .25 percent, compared to Ginnie Maes that pay .44 percent.

Further, the loan servicing portfolio is, as financial analysts indelicately describe it, a wasting asset. Principal balances are paid down monthly, and the fee from the investor is fixed as a percentage of the outstanding principal balance. As a result, the mortgage banker must continually "feed" her servicing portfolio to maintain profit levels.

All of this means a profit squeeze in a low volume market. The search for loans to support the servicing portfolio is becoming intensive, and the market for servicing sales--bulk and individual loan (wholesale)--is beginning to heat up. Lenders are particularly fearful as rates continue to slide in the face of lackluster demand; an increase in loan payoffs could accelerate the reduction in the servicing portfolio, with the new loan landing in another mortgage banker's file.

So once again we are seeing creative marketing on the part of lenders in an attempt to maintain a modicum of volume. But in addition to the traditional marketing techniques, usually price-based, we can expect some interesting twists this time around.

One theme is convertibility--a mortgage that can flip into a fixed rate loan at some date in the future at the borrower's option. The concept isn't new, but an interesting variation has developed. It permits a fixed rate borrower to switch into a lower fixed rate loan. The idea has developed to a large extent as a means of allowing the mortgage banker to retain in portfolio a loan that might otherwise have disappeared through refinancing.

Both Fannie Mae and Freddie Mac offer purchase programs for these loans, but borrowers have so far been less than enthusiastic.

The message here is that we are likely to see other mortgage product variations develop if these market conditions persist. Mortgage bankers will increasingly become concerned about maintaining profitable servicing portfolios, and a new wave of oddball mortgages is likely to result.

DETAILED OVERVIEW OF MAJOR REAL ESTATE-RELATED PROVISIONS OF NEW TAX LAW

by
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INDIVIDUAL INCOME TAX

Home Mortgage Interest

The new law changes the limits on the deduction of home mortgage interest for mortgage debt incurred after October 13, 1987, as follows:

- Interest is deductible on mortgage "acquisition indebtedness" up to a total $1 million covering one or two homes. However, the deduction can be taken only to the extent that the money borrowed is used to finance the purchase or improvement of the home; and, the indebtedness limit is reduced as principal payments are made and cannot be increased by refinancing unless the additional amount is used for improvements.
- In addition to interest on acquisition indebtedness, interest may be deducted on home equity indebtedness (one or two homes) up to $100,000, irrespective of the purpose of the borrowing, provided the debt does not exceed the fair market value of the home(s).
- Interest on mortgage debt (one or two homes) incurred before October 14, 1987, is generally deductible in full after 1987. However, all mortgage debt incurred before October 14, 1987 and still outstanding is "counted" toward the new $1 million limit, but not toward the $100,000 limit.

Publicly Traded Partnerships

For tax years beginning after 1987, certain publicly traded partnerships will be treated as corporations for Federal income tax purposes. Those not so treated include certain partnerships where 90 percent or more of the gross income of the partnership consists of "passive-type income" and partnerships that qualify for a grandfather rule.

In determining whether income is treated as passive-type income in the case of interest and real property rents, amounts that are contingent on profits will not be treated as interest or rent. However, real property rents based on a fixed percentage of receipts or of gross sales are not excluded from rents that are treated as passive-type income. Passive-type income does not include income from rental or leasing of personal property.

In effect, although most Master Limited Partnerships will be taxed as corporations, publicly traded partnerships can avoid corporate taxation if 90 percent or more of the income is derived from real estate and natural resource activities. Also, this legislation recharacterizes the income from any publicly traded partnership as portfolio income that cannot offset passive losses under the passive loss limitation. However, non-publicly traded partnerships are not subject to the above limitation.

In the case of a partnership that is treated as a corporation, the partnership is treated as contributing all of its assets (subject to all of its liabilities) to a newly formed corporation in exchange for all of the corporation's stock. The stock of the corporation is treated as distributed to the partners in complete liquidation of the partnership.

Publicly Traded Partnerships Under the Passive Loss Rules

Certain publicly traded partnerships are exempt from the provision that requires them to be taxed as corporations. The passive loss provisions will continue to apply to these partnerships at the partner level. However,

- Net income from these publicly traded partnerships is treated as portfolio income.
- Income and loss from each publicly traded partnership is treated separately by a partner.
- Losses may not be used to offset regular portfolio income (as defined under the passive loss rules as they generally apply) from the partnership.
- Unused losses are suspended and may be carried forward until the publicly traded partnership generates income or until the partner disposes of his or her entire interest in the activity.

Credits from a publicly traded partnership may be used only to offset the partner's income tax liability attributable to the same partnership interest. Partners are entitled to the $25,000 (deduction equivalent) allowance with respect to rehabilitation and low-income housing credits from the activity. The provision applies to tax years beginning after 1986.

Partnership Allocations

The new law places restrictions on the ability of a partnership with both tax-exempt and taxable partners to make disproportionate allocations of income, gain, loss, and deduction among the partners to take advantage of the tax-exempt entity. This provision applies to property acquired by the partnership after October 13, 1987, and for partnership interest acquired after October 13, 1987.

ACCOUNTING METHODS

Partnership, S Corporation, and Personal Service Corporation Year-Ends

For years beginning after 1986, partnerships, S corporations, and personal service corporations generally are required to change to their owners' tax year. Partnerships and most S corporations can elect to retain their pre-1987 tax year provided the entity pays additional tax based on a formula that estimates the tax that would have been paid if the required change had been made. The new law allows calendar-year S corporations that elected S corporation status from September 19, 1986 to December 31, 1987 to use a fiscal year if the deferral period of such year is not longer than the shorter of three months or the deferral period of the year used prior to the S corporation election.

The new law allows a personal service corporation to elect to retain its pre-1987 tax year. If the election is made, payments to employee-owners must be made prorata throughout the year, or a portion of the deduction for such amounts is deferred until the next tax year.

Installment Sales

Dealer sales. The installment method of reporting gain is not available for post-1987 "dealer" sales of real or personal property. Specifically, installment method reporting is precluded for:

- dispositions of personal property by a company that regularly sells such property on an installment plan; and
- dispositions of real property that is held by a company for sale to customers in the ordinary course of business.

Gain on these dispositions must be reported in full upon sale.

Companies selling timeshares or residential lots may elect to continue to use the installment method, but must pay interest to the government on the amount of taxes deferred by the use of the method. Also, the repeal of the installment method for dealers does not apply to sales of farm property.

Non-dealer sales. The new law repeals the proportionate disallowance rules for non-dealers. These rules required the inclusion in income of a percentage of deferred gain determined based on the seller's debt-to-asset ratio.

In lieu of the proportionate disallowance rules, the new law imposes certain restrictions on installment sales of business or rental real property (except farm property) with a selling price in excess of $150,000.

- To the extent that a company's total amount of installment receivables of this type arising during any year and outstanding at the end of that year exceeds $5,000,000, interest is owed to the government on the deferred tax attributable to such excess.
- After December 17, 1987, the pledging of these installment receivables as security for a loan will trigger full reporting of gain (under prior law pledges were not treated as dispositions).

For non-dealers selling business or rental real property, the installment method may be used (for tax years after 1986) for purposes of computing alternative minimum taxable income on any non-dealer sales.

The changes regarding non-dealers are effective for sales in tax years beginning after 1987. However, companies and individuals may elect to apply the new law to all sales after August 16, 1986.

Estate and Gift Taxes

Rates

The new law continues for five years the two highest gift-estate tax brackets (53 percent for amounts between $2.5 million and $3 million and 55 percent over $3.0 million). These rates were previously scheduled to drop to 50 percent on January 1, 1988. The new law also phases out the benefit of the unified credit and graduated rates for transfers exceeding $10 million but less than $21,040,000 for decedents dying before 1992 by imposing an additional five percent tax on those transfers.

Estate Freezes

The new law includes a provision that could cause the value of certain transferred property to be included in the gross estate of a decedent.

The new rules are potentially applicable to transfers of stock after typical estate freeze corporate recapitalizations, as well as to transfers of partnership interests or other interests in income or gain-producing property.

Estate Tax Deduction for Sales to ESOP

An estate tax deduction for transfers to an ESOP is not available unless the decedent directly owned the employer securities just before death, and after the sale, the employer securities are allocated to plan participants or are held for future allocation under a leveraged ESOP or in connection with a transfer of assets from a terminated defined benefit plan. The new law limits the deduction to sales of securities of employers whose stock is not publicly traded. The deduction is limited to 50 percent of the taxable estate, and in addition, the amount of estate taxes may not be reduced by more than $750,000 by reason of the deduction.

If qualified securities for which a deduction was claimed are disposed of within three years of the sale qualifying for the estate tax deduction an excise tax is imposed upon the ESOP.

OTHER TAX PROVISIONS (NON-REAL ESTATE)

FICA Tax

The new law extends FICA taxes and Social Security coverage, effective January 1, 1988 to:

- All cash tips (up to the Social Security wage base);

- A spouse employed by his or her spouse and certain children employed by parents;
- Armed services reservists "in active duty training,"
- Certain agricultural workers;
- Employer-provided group-term life insurance if it is includable for income tax purposes (if the coverage exceeds $50,000 or is provided on a discriminatory basis).

FUTA Tax

The new law extends the 0.2 percentage point surtax on the Federal unemployment tax rate for three years.

Excise Taxes

The three percent telephone excise tax, scheduled to expire after December 31, 1987, has been extended through December 31, 1990.

Source: Coopers and Lybrand, "An Overview of the Principal Provisions of the 1987 Tax Act," Tax Notes, pp. 67-75, January 4, 1988.

TAX AND BUDGET OVERVIEW: POLITICS, ECONOMICS AND THE 1988 BUDGET PROCESS

by
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On Thursday, February 19, the President released his budget for Fiscal Year 1989, to take effect October 1, 1988. Of course, this is an election year and the political climate will dictate a low-profile on taxing and spending. Consequently, Washington political mavens are predicting that there will be no major battles in Congress or between Congress and the President this year.

The Taxation Outlook

Technical corrections is expected to be one of the few tax games in town this year. Since 1988 is an election year, Congress is not expected to make any serious attempts to raise revenue. Of course, the deficit prevents Congress from making any significant revenue-losing changes as well. Most observers predict that Congress will be content with just adding some of the "miscellaneous" revenue losers that were dropped from the original reconciliation bills to the technical corrections bill.

However, there may be some efforts to make significant tax changes. Proponents of restoring a capital gains tax preference are expected to push hard for their proposals this year and may receive more serious attention than they did last year.

The Current Budget Timetable

In the next few weeks, the House and Senate Budget Committees will begin hearings on the President's budget. After that, each panel will draft a budget for overall spending, revenue and deficit levels for broad categories of government activities. Currently, the House plans to have a budget ready for a vote of the House by the third week in March. The Senate is planning for the end of April. Differences are expected to be resolved by the end of May.

Following the approval of the budgets, the respective houses' appropriation committees are expected to start work in early summer on spending bills to implement these spring budget resolutions. It is hoped that final action can be completed by both chambers before October.

The Budget Accord passed in late 1987, provides some common ground on taxing and spending for FY 1988 and FY 1989. Therefore, some of the rules have already been set. However, a factor that could cause some problems is the growth rate of the economy and its impact on the budget deficit.

Assumptions On the Economy and the Deficit

Under the terms of the 1987 Budget Accord (see January 1988 issue of Real Estate Outlook), the deficit was expected to fall within the target levels set by the Gramm-Rudman-Hollings (GRH) law - $144 billion in FY 1988 and $136 billion in FY 1989. Actually, there is a $10 billion "fudge-factor," so if the FY 1989 deficit is expected to be $146 billion, it will still be considered acceptable, and therefore avoid any across-the-board cuts via sequestration of federal spending.

Private forecasters have estimated the budget deficit could reach $158 billion in FY 1988 and $167 billion in FY 1989. The trick is the economic assumptions used by the Administration to project the FY 1989 deficit.

In February, the Congressional Budget Office (an economic research arm of Congress) presented its economic assumptions to Congress. The CBO forecast economic growth of 1.8 percent for 1988 and 2.6 percent in 1989 (based on fourth quarter to fourth quarter [4Q to 4Q] percentage changes). It also predicted: a 3.9 percent increase in the GNP Deflator for 1988 and 4.2 percent in 1989; and, 4.9 and 4.8 percent increases for 1988 and 1989, respectively, in the urban CPI. In terms of the civilian unemployment rate, CBO is forecasting 6.2 and 6.1 percent calendar-year averages for 1988 and 1989. Interest rates (calendar-year averages) are forecast to be 9.3 and 9.5 percent on 10-year Treasury bonds; and 6.2 and 6.7 percent for 3-month Treasury bills for the two years. These assumptions lead to deficit projections of $157 billion in FY 1988 and $176 billion in FY 1989. Both exceed the GRH targets (including the "fudge factors").

The Administration's Assumptions

The President's men are assuming real GNP growth (4Q to 4Q) of 2.4 and 3.5 percent; CPI inflation of 4.3 and 3.9 percent (4Q to 4Q); an overall unemployment rate of 5.8 and 5.5 percent; and an average annual interest rate on 91-day Treasury bills of 5.3 and 5.2 percent for 1988 and 1989, respectively. These more optimistic expectations have allowed the Administration economists and budgeters to forecast deficits of $146.7 for FY 1988 and $129.5 for FY 1989, well within the GRH targets.

A Summing Up

The Administration is taking a considerably more optimistic view of the economic future than is the CBO or